UNITED STATES DISTRICT COURT

DISTRICT OF MAINE

CARLOS J. QUIJANO, et al.,	***)***	
	)	
Plaintiffs	***)***	
	)	
v.	***)***	***Civil No. 94-381-P-C***
	)	
UNITED STATES OF AMERICA,	***)***	
	)	
Defendant	***)***	

RECOMMENDED DECISION ON CROSS MOTIONS FOR SUMMARY JUDGMENT

The plaintiffs seek to recover an overpayment of their 1990 federal income tax. The parties filed cross motions for summary judgment,[1] and have since agreed to have the case decided on the basis of a stipulated record. *See Boston Five Cents Sav. Bank v. Secretary of the Dep't of Housing & Urban Dev.*, 768 F.2d 5, 11-12 (1st Cir. 1985). For the reasons set forth below, I recommend that judgment be entered in favor of the plaintiffs in the amount of $2,668, plus applicable interest and penalties as provided by law.

I. Facts and Procedural History

The plaintiffs bought a residence in London, England on September 30, 1986 for 297,500 Pounds Sterling ("pounds"). Stipulation of Facts (Docket No. 5) ¶ 6. They financed the purchase in full in

[1] The defendant filed a partial motion for summary judgment because it agrees that the plaintiffs have overpaid, but disagrees as to the extent of the overpayment. The parties have stipulated that, under the defendant's method of calculation, the plaintiffs are entitled to an overpayment of $2,668, plus applicable interest and penalties as provided by law. Stipulation for Decision on the Written Record (Docket No. 14) at 1 n.1.

England with a mortgage loan from Mr. Quijano's employer. *Id.* While they owned the residence, the plaintiffs made capital improvements totaling 45,647 pounds. *Id.* ¶ 7. At no time did they use United States funds to purchase or improve the residence. *Id.* ¶ 9. They refinanced the loan in 1988 for 300,000 pounds, and again in 1990 for 333,180 pounds. *Id.* ¶ 8. On July 27, 1990 the plaintiffs sold the residence for a net price of 453,374 pounds. *Id.* ¶ 10.

The plaintiffs filed a federal tax return for 1990 in which they included $308,811 in capital gain from the sale of the residence. *Id.* ¶¶ 5-6. To calculate their adjusted basis in the residence, the plaintiffs used the exchange rate in effect at the time of purchase, 1.49 U.S. dollars ("dollars") to 1 pound. *Id.* ¶ 11. The plaintiffs later filed an amended return, claiming a reduction in capital gain from $308,811 to $199,491. *Id.*¶ 5. To calculate the adjusted basis as reflected on the amended return, the plaintiffs used the exchange rate in effect as the time of sale, 1.82 dollars to 1 pound. *Id.* ¶ 11. On January 14, 1994, after reviewing the plaintiffs' amended return, the Commissioner of Internal Revenue refused to remit to the plaintiffs the $30,610 they claim to have overpaid. *Id.* ¶ 12.

II. Legal Analysis

A taxpayer's gross income includes gain from dealings in property. 26 U.S.C. § 61(a)(3). Gain from the sale of property equals the excess of the amount realized over the adjusted basis. *Id.* § 1001(a). The adjusted basis is the cost of the property adjusted for certain expenditures, including capital improvements. *Id.* §§ 1011(a), 1012, 1016(a)(1).

In 1986, Congress added "Subpart J -- Foreign Currency Transactions" to the Internal Revenue Code. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1261(a), 100 Stat. 2085, 2585-91. Taxpayers must make all Subtitle A (Income Taxes) determinations, including amount realized and adjusted basis,

in their functional currency. 26 U.S.C. §§ 985(a) and 1001(a). "Functional currency" means the dollar, except in the case of a qualified business unit. *Id.* § 985(b). The plaintiffs concede that they did not operate as a qualified business unit, so their functional currency is the dollar.

A. Separate Treatment of the Loan and the Residence

For purposes of determining gain or loss, borrowing and repayment of foreign currency are treated separately from the purchase and sale of property acquired with the borrowed currency. *Federal Nat'l Mortgage Ass'n v. Commissioner*, 100 T.C. 541, 582 (1993); *see* Rev. Rul. 90-79, 1990-38 I.R.B. 26. This is true even where the borrowing arose only for the sake of the underlying transaction. *Federal Nat'l Mortgage Ass'n*, 100 T.C. at 583. Thus, to the extent that the plaintiffs sustained an exchange loss[2] on repayment of the loan, they may not offset that loss against the gain realized from sale of their residence. Rev. Rul. 90-79 (citing 26 U.S.C. § 165) (limiting losses that individuals may deduct)).

The plaintiffs argue that Rev. Rul. 90-79 contains a fundamental flaw: if they had sold their house for the same amount in pounds as they paid for it, they would have a taxable profit because of the different exchange rates, even though they had no "real economic gain" from which to pay the tax. Ironically, this example illustrates the fundamental flaw in the plaintiffs' own argument. It is true that there would be no gain in pounds. Congress, however, requires the plaintiffs to calculate gain in the their functional currency: the dollar. 26 U.S.C. § 985(a), (b). In dollars, they *would* have a "real economic gain" because a given number of pounds was worth more dollars in 1990 than in 1986.

Before Congress enacted Subpart J, the conference committee noted that pre-1986 law treated

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[2] "Exchange gain" and "exchange loss" refer to gain or loss arising from fluctuations in the value of foreign currency. H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. II-659, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4747.

exchange gain or loss separately from gain or loss attributable to an underlying transaction. H.R. Conf. Rep. No. 99-841 at II-662, 1986 U.S.C.C.A.N. at 4750. The committed observed that such separate treatment would continue in the case of "foreign currency gain or loss recognized by a U.S. individual residing outside of the United States upon repayment of a foreign currency denominated mortgage on the individual's principal residence." *Id.* at II-669, 1986 U.S.C.C.A.N. at 4757. That is precisely the situation in this case. The factual differences between cases cited in Rev. Rul. 90-79 and the present case do not undermine its applicability here. The committee's interpretation of pre-1986 law reinforces the interpretation set forth in Rev. Rul. 90-79.

Section 165(a) provides a deduction for uncompensated losses. Individuals, however, may only use this deduction for losses incurred in a trade or business, losses incurred in a transaction entered into for profit, and casualty or theft losses. I.R.C. § 165(c). Thus, the plaintiffs may not offset the loss realized on repayment of the loan against the gain realized from the sale of their residence. *Id.*; Rev. Rul. 90-79.

B. Applicable Exchange Rates

Determining gain in their functional currency requires the plaintiffs to report the cost and selling price of their residence "at the rate of exchange prevailing as of the date of the purchase and the date of the sale, respectively." Rev. Rul. 54-105, 1954-1 C.B. 12; *see also* Rev. Rul. 78-281, 1978-2 C.B. 204. Similarly, they must report the cost of capital improvements at the exchange rate prevailing on the date of each expenditure. *See* Rev. Rul. 54-105; *see also* Rev. Rul. 78-281.

The plaintiffs assert that only the exchange rate prevailing on the date of sale should be used to determine their adjusted basis. Otherwise, they argue, they will be taxed on "phantom gain," the

increased value of the pound relative to the dollar. As the plaintiffs concede, however, had they converted dollars into pounds to purchase their residence they would have realized an "actual" gain when they sold it. The Internal Revenue Code treats the transaction as if the plaintiffs *had* converted dollars into pounds to make the purchase, because they must determine adjusted basis in their functional currency: the dollar. Accordingly, the plaintiffs must determine the cost in dollars of the purchase price and capital improvements based on the prevailing exchange rates at the time of each expenditure. *See* Rev. Rul. 54-105; *see also* Rev. Rul. 78-281.

C. Sixteenth Amendment

The plaintiffs claim that they never realized the exchange gain on the residence, so that gain is not taxable income under the Sixteenth Amendment.[3] *See Eisner v. Macomber*, 252 U.S. 189, 207, 211 (1920) (receipt of stock dividend is not income because it is not realization of profits for stockholder's own use). As the value of the pound increased relative to the dollar, the value of the plaintiffs' residence, measured in dollars, also increased. The plaintiffs realized the economic benefit of that currency gain when they sold their residence. The currency gain, therefore, constitutes taxable income within the meaning of the Sixteenth Amendment.

III. Conclusion

Accordingly, I recommend that judgment be entered in favor of the plaintiffs in the amount of $2,668, plus applicable interest and penalties as provided by law.

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[3] "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

NOTICE

A party may file objections to those specified portions of a magistrate judge's report or proposed findings or recommended decisions entered pursuant to 28 U.S.C. § 636(b)(1)(B) for which de novo review by the district court is sought, together with a supporting memorandum, within ten (10) days after being served with a copy thereof. A responsive memorandum shall be filed within ten (10) days after the filing of the objection.

Failure to file a timely objection shall constitute a waiver of the right to de novo review by the district court and to appeal the district court's order.

Dated at Portland, Maine this 14th day of November, 1995.

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David M. Cohen
United States Magistrate Judge